Service Date: October 2, 1978

DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

IN THE MATTER of the application of MOUNTAIN STATES TELEPHONE AND TELEGRAPH COMPANY for authority to establish increased rates for telephone service.	)))))	DOCKET NO. 6496 ORDER NO. 4389d

APPEARANCES

APPLICANT:

GEORGE T. BENNETT, Attorney at Law, 406 Fuller Avenue, Helena, Montana, appearing on behalf of the Applicant.

DENIS G. STACK, Attorney at Law, 931-14th Street, Denver, Colorado, appearing on behalf of the Applicant.

ALAN C. DEMUTH, Attorney at Law, 718-17th Street, Denver, Colorado, appearing on behalf of the Applicant.

PROTESTANT:

GEOFFREY L. BRAZIER, Montana Consumer Counsel, 34 West 6th Avenue, Helena, Montana, appearing on behalf of the consuming public of the State of Montana.

JOHN C. DOUBEK, Attorney at Law, 34 West 6th Avenue, Helena, Montana, appearing on behalf of the Montana Consumer Counsel.

WILLIAM E. O'LEARY, Attorney at Law, 631 Helena Avenue, Helena, Montana, appearing on behalf of the Montana Consumer Counsel.

INTERVENOR:

ROGER TIPPY, Attorney at Law, P.O. Box 475, Helena, Montana, appearing on behalf of Executone Systems of Montana.

BRUCE P. SAYPOL, Attorney at Law, 1920 L Street NW, Washington, D.C., appearing on behalf of Executone Systems of Montana.

DOCKET NO. 6496, ORDER NO. 4389d

FOR THE COMMISSION:

DENNIS R. LOPACH, Counsel
WILLIAM J. OPITZ, Executive Director
FRANK E. BUCKLEY, Administrator, Utility Division
J. DAVID BURCHETT, Auditor
JUDITH M. CURTIS, Economist

BEFORE:

GORDON E. BOLLINGER, Chairman
P. J. GILFEATHER, Commissioner
THOMAS J. SCHNEIDER, Commissioner
JAMES R. SHEA, Commissioner
GEORGE TURMAN, Commissioner

FINDINGS OF FACT

PART A

GENERAL

1. Mountain States Telephone and Telegraph Company (Applicant, Mountain Bell or Company) is a public utility furnishing telecommunication services to customers in the state of Montana. This Commission has jurisdiction over the rates and charges for utility service and the conditions under which such service is rendered.

2. On March 14, 1977, Mountain Bell filed with this Commission its application for authority to increase rates and for the approval of tariff changes for telecommunication services provided its Montana customers. The proposed permanent rate changes would generate $11.83 million of additional yearly revenues.

3. Included with the Company's application was a request for approval of interim rates. The interim changes proposed would have generated $4.246 million in revenue during 1977 had they been approved by May 1 of that year.

4. The Commission held a pre-hearing conference on May 6, 1977 and subsequently issued its order of procedure in this Docket.

5. On August 2, 1977, Applicant's request for an interim rate increase was denied. The denial was without prejudice to Mountain Bell's right to renew the request.

6. A second pre-hearing conference was held on August 12, 1977; a revised order of procedure was issued on August 19, 1977.

7. After having been duly noticed, hearings on Phase I of Docket No. 6496 commenced on November 1, 1977 in Helena, Montana and concluded November 8, 1977. During the course of the hearings, Mountain Bell renewed its request for interim rate relief.

8. By order No. 4389a, a temporary rate increase of $870,918 was granted on March 13, 1978. The increased revenues were to be realized from the regrouping of certain exchanges in accordance with existing tariffs.

9. On April 4, 1978, Phase II hearings began and continued through April 12, 1978. Again, Mountain Bell requested interim rate increases.

10. Through Order Nos. 4389b and 4389c, the Commission allowed the regrouping of five exchanges and increases in rates for private branch exchange, centrex, key telephone and private line services on an interim basis. These two Orders permitted a revenue increase of approximately $1,455,082 for total interim relief of $2,326,000. The total is equal to the increase found appropriate by Consumer Counsel witnesses.

11. The office of the Montana Consumer Counsel has participated in the proceedings of this Docket since their inception.

PART B.

RATE OF RETURN

Capital Structure

12. Applicant sought an "objective" capitalization for the Company which it quantified as follows:

Type of Capital	Percent of Capitalization
Debt	45.0
Equity	55.0

(Exhibit 4, Table 31)

The objective capital structure was based on the utility's "current objectives...to obtain a 45% maximum debt ratio." (Exhibit 3A, p. 8, 11. 17-18).

13. Consumer Counsel witness Dr. Wilson recommended an adjusted December 31, 1976 capital structure as follows:

Type of Capital	Percent of Capitalization
Debt	44.65
Common Stock	55.35

(Exhibit D, Exhibit J.W.-18, Page 2 of 3)

Wilson adjusted the actual year-end capital structure for debentures redeemed on January 3, 1977 and for a rights offering on February 23, 1977.

14. Little difference exists between the recommendations of Mountain Bell and Wilson. Because it reflects actual figures with adjustments for known and measurable changes, the capital structure proposed by the Consumer Counsel witness is found appropriate.

Cost of Debt

15. Company witness Danner determined 7.37 percent as the average embedded cost of debt for Mountain Bell during 1976. A second company rate of return witness, Mr. LaBlanc, gave 7.59 percent as the yearend embedded cost of funded debt.

16. As calculated by Dr. Wilson, Mountain Bell's embedded cost of debt was 7.26 percent as of December 31, 1976, including adjustments for 9 percent debentures redeemed January 1977.

17. The cost of debt computed by Dr. Wilson is accepted since it recognizes changes in the Applicant's financing costs which occurred shortly after the end of 1976.

Cost of Equity

18. Mountain Bell's witness, Mr. Danner, concluded that the Company should be allowed a return of 14 to 15 percent on its book equity. His conclusion was based on two types of analysis:

(A) an examination of historical spreads between common equity returns and corporate bond yields. Danner found that, over various time periods, common stocks have averaged a return which exceeded that of bonds by a minimum of 5 ½ percent. With then-current bond yields of 8 to 8 ½ percent, this analysis suggested that equity investors required market returns of 13 to 14 percent.

(B) application of the discounted cash flow (DCF) methodology to Mountain Bell's common stock. A current dividend yield of 7 percent coupled with 6 to 8 percent anticipated growth in dividends, an estimate by Danner, corresponded with a required market return of 13 to 15 percent.

Because he felt that a market-to-book ratio of 1.2 was necessary to prevent dilution, Danner converted the 13 to 14 percent market return to a 14 to 15 percent book return.

19. Mr. Danner has not shown that the risks associated with ownership of the common stocks utilized in (A) above are comparable to those faced by the Applicant's stockholders. Price-earnings ratios do not encompass all aspects of risk. While the DCF method is an accepted means of determining the required return on equity in regulatory hearings, the methodology must properly be applied to a sample of comparable-risk companies, rather than a single utility as Mr. Danner has done. The conclusions of Danner's testimony are rejected since he has not shown that his recommended return is derived from an analysis of comparable-risk companies.

20. The second witness for the Applicant, Mr. LaBlanc, relied on professional contacts with utility investors in his return recommendation. Based on these contacts and on the addition of a 5 percent equity-debt spread to new triple-A bond yields, LaBlanc stated that investors required a minimum return in the 13.5 to 14.5 percent range on shares of Mountain Bell's common equity. Like Danner's testimony, that of LaBlanc does not include an analysis of comparable-risk companies and is rejected.

21. Wilson, witness for Consumer Counsel, recommended that the Applicant be allowed an 11.25 percent return on equity. His recommendation resulted from comparable earnings analysis and the DCF approach. In the comparison of earnings, Wilson found that Bell System companies have earned rates of return on book equity below those of independent telephone companies, electric utilities and the average for all unregulated companies. Wilson stressed the importance of a comparison with unregulated firms to avoid the problems of circularity, that is, using the results of past regulatory decisions as a basis

for those currently made. As applied by Wilson, the DCF approach relied on the financial analysis of 100 electric utilities as well as Mountain Bell data. This approach suggested that an 11 percent return on equity is required by the Company's stockholders. To this required return, Wilson added 0.25 percent as an allowance for market pressure and underwriting expenses.

22. Dr. Wilson's testimony relied on analysis of both Mountain Bell and other companies facing similar risks. Although the Company's witnesses recommended a higher rate of return than that proposed by Wilson, Danner admitted under cross-examination (Trans., Vol. I, p. 152, ll. 15-20) that the Company's stock was then selling above book value with the actual return on equity nearly equal to Wilson's recommendation (Exhibit 4, Table 27). Because the Applicant has not demonstrated that a 14 to 15 ½ percent return on equity is required, an 11.25 percent return is accepted as adequate.

Double Leverage

23. Giving consideration to the rights offering of May 1977, the American Telephone and Telegraph Company owns 88.55 percent of Mountain Bell's outstanding common stock. AT&T's equity investment in Mountain Bell is financed by a combination of debt, preferred stock and common stock. The weighted cost of this financing is 9.86 percent determined as follows:

Type of Capital	Percent of Capitalization	Cost	Weighted Cost
Debt	23.1	6.47%	1.49%
Preferred Stock	8.0	7.82%	0.63%
Common Stock	68.8	11.25%	7.74%
			9.86%

(Exhibit D, Exhibit J.W.-18, page 1 of 3)

24. Since AT&T bears a financing cost of 9.86 percent on its equity investment in Mountain Bell, a return no greater than this percentage should be allowed on that portion of

Applicant's common stock held by the parent company. The 11.25 percent return on common equity permitted in Finding of Fact No. 22 applies only to the minority shareholders. To allow this higher return on AT&T's investment would provide excessive compensation to the American Company at the expense of Montana ratepayers who should properly share in the cost savings of AT&T's debt financing.

25. Based on previous Findings 14, 17, 22 and 24, the Commission finds an 8.78 percent rate of return, calculated as follows, to be fair and reasonable:

Type of Capital	(000) Amount	Percent of Capitalization	Cost	Weighted Cost
Debt	$1,530,503	44.65	7.26%	3.24%
Equity-Supplied by AT&T	1,679,869	49.01	9.86%	4.83%
Supplied by Minority Shareholders	217,216	6.34	11.25%	0.71%
TOTAL	$3,427,588			8.78%

PART C
RATE BASE AND OPERATING RESULTS
Test Year

26. Mr. Leake, the Applicant's witness who testified on revenue requirements, recommended use of 1977 budget forecasts as the test year. In support of his recommendation, Leake pointed to what he felt was the high level of accuracy in past forecasts compared with actual results.

27. Consumer Counsel witness Hess contended that a test year ending June 30, 1977 was preferrable to Company forecasts. Hess gave two reasons for not relying on predictions: (A) those outside the Company cannot verify forecasted figures; and (B) basing utility rates on forecasts reduces management's incentive to control costs. The test year ended June 30, 1977 was selected by Hess since it was the most recent for which financial information was available.

28. The Commission accepts a test year ended June 30, 1977 in this proceeding, believing that the most recent historical figures available, adjusted for known and measurable changes, are the proper basis for rate-making decisions.

Rate Base

29. With his 1977 forecasted test year, Leake utilized a projected 1977 average rate base in his revenue requirements calculations. The forecasted base was advanced as a means of minimizing the secular attrition of earnings he anticipated.

30. Consumer Counsel witness Hess recommended adoption of an average year rate base corresponding with the year ended June 30, 1977. His recommendation was premised on the contention that an average rate base resulted in the best match between operating income and investment.

31. The Commission agrees with Hess as to the appropriateness of an average rate base for the year ended June 30, 1977. Use of an historic test year allows adjustment for known and measurable changes.

32. The Commission finds the following rate base:

Average Rate Base
for the Year Ended June 30, 1977
(000)

1. Average Plant in Service	$188,194
2. Plant Held for Future Use	7
3. Depreciation Reserve	(46,096)
4. Net Plant	$142,105
5. Customer Contributed Capital	
6. Accumulated Deferred Income Taxes	(10,993)
7. Unamortized Pre-1971 Investment Tax Credits	(645)
8. Total Average Rate Base	$130,467

(Exhibit K, Schedule 6)

33. Construction work in progress was excluded from the rate base because these assets are not used and useful in serving current ratepayers.

34. The Applicant has failed to show that working capital, including both cash working capital and materials and supplies, was provided by the Company's debtors and stockholders, necessitating its inclusion in the rate base. Consequently, the Applicant's request for an allowance for working capital is denied.

35. While the items found in Lines 1 through 3 represent assets used and useful in providing service to customers, not all the funds for asset acquisition are investor supplied. The amounts of accumulated deferred income taxes and unamortized pre-1971 investment tax credits in Lines 6 and 7 are subtracted from rate base; the Commission finds this adjustment proper to allow for customer-contributed capital.

Revenues and Expenses

36. Applicant's books showed operating revenues of $68,877,000 for the year ended June 30, 1977.

37. In response to data requests from Hess, the Company supplied information which allowed out-of-period and pro forma revenue adjustments. These adjustments were for independent company settlements and directory advertising increases; adjusted operating revenue was found to total $69,312,000 for the test year ended June 30, 1977.

38. Actual operating expenses during the year were also changed by out-of-period and pro forma adjustments to allow use of the period as a test year. The necessary adjustments to operating expenses involved an increase in depreciation rates, the annualization of wage increases, greater costs for employee benefit plans and higher commercial expenses resulting from directory advertising rate increases. In combination, these adjustments caused operating expenses to rise by $2,328,000.

39. Because certain operating revenue and expenses categories have been adjusted to permit use of the period as a test year, the Company's tax liabilities must be changed to reflect the new level of net operating revenues. Additionally, operating taxes were adjusted for the effects of prior years' taxes, the 1977 Social Security tax increase, debt refinancing and a lower debt ratio soon after the close of the test year. The combined impact of these changes is a reduction in total operating taxes of $948,000 to $11,306,000.

40. The changes outlined in Findings 37, 38 and 39 and quantified in Schedule 3 of Exhibit K were agreed to by both the Applicant and Hess with the exception of the adjustment for adoption of Equal Life Group depreciation. While Leake, witness for

Mountain Bell, proposed an increase in test-year expenses based on the expectation of FCC approval of the change in depreciation method, Hess argued that no adjustment should be made at that time. The Commission finds that no change in depreciation expense should be made before the FCC rules on the petition before it. The remaining adjustments described in Findings 37, 38 and 39 and accepted by Hess are found to be appropriate by this Commission.

41. Hess recommended utilization of historic productivity gains to reduce the expenses associated with labor during the test year. He argued, "if test year operating expenses are to be adjusted upward for post-test-year wage and benefit increases they should be correspondingly adjusted downward to reflect productivity gains reasonably anticipated." (Exhibit K, p. 14, ll. 12-16). The Commission rejects this line of reasoning on two grounds: (1) Hess has not shown a cause-and-effect relationship between the higher wages and increased productivity; other factors such as growing telephone plant may be responsible for the expanded output per man-hour; and (2) this Commission declines to base ratemaking decisions on projections of the future; anticipated productivity gains are such a forecast.

42. For the year ended June 30, 1977, the Applicant originally claimed $277,000 of advertising expenditures applicable to Montana intrastate operations. Upon consideration of Montana statute, R.C.M. 1947, 70-121.1, the Company conceded in the supplemental testimony of its witness, Mr. Buckley, that most of the total was not allowable and advertising expenses should be reduced to $88,000 for ratemaking purposes. The Commission agrees with the company that $88,000 of advertising expenses were exceptions to the Montana law and were, thus, an allowable expense. Consequently, commercial expenses for the test year must be reduced by $189,000, the difference between total advertising expenses of $277,000 and the allowed amount, $88,000.

43. Following a change in policy which occurred in 1974, the level of license contract fees Mountain Bell paid AT&T has been equivalent to an allocated share of the costs incurred by the parent company in providing services covered by the contract. For 1977 Applicant's estimated payment was $1,167,000 for Montana intrastate or an amount equal to approximately 1.83 percent of gross operating revenues less uncollectibles.

44. Mr. Gabel, witness for the Consumer Counsel, recommended that the allowed expense for license fees in this proceeding be limited to one percent of gross operating revenues. Gable argued that a substantial proportion of the activities funded under the

license contract benefits only stockholders in the American Company; thus, their costs should be borne by AT&T's shareholders rather than Montana ratepayers. Further, Gabel contended that license fees support basic research and fundamental development which directly aid Western Electric, not the telephone subscriber. For these two reasons, Gabel suggested that fees above one percent of gross operating revenues be disallowed for ratemaking purposes.

45. Mountain Bell presented two witnesses, Messrs. Dennis and Schneider, who argued that the benefits to Montana intrastate ratepayers of services performed under the license contract justified the costs charged Applicant by AT&T. Both men supplied extensive lists of the activities supported by license fees, alleging that each activity served ratepayers. In addition, Schneider contended that were the Applicant to acquire license contract services independently of its parent, the costs would be much greater than they currently are. (Exhibit 10A, p. 16, 11. 7-11).

46. This Commission finds Mountain Bell has failed to demonstrate that services performed under the license contract benefit Montana ratepayers to the extent of the payment made to the American Company. As a consequence, the Commission declines to characterize the entire amount of the license contract payment as a reasonable expense. Mountain Bell witnesses attempted to show the reasonableness of the expense by comparing the license fee with the alleged costs to Applicant of providing all these services on its own; they concluded that the payment to AT&T was less than the costs of independent provision by Mountain Bell. However, the Applicant has not shown that each service performed under the license contract benefited Montana ratepayers and would have been supplied by Mountain Bell had the license contract not existed. Gabel questioned the propriety of having telephone subscribers to bear the expense of certain activities, funded by license fees, which he describes as "holding company functions." (Exhibit CC-P-1, p. 4). This question and others concerned with the benefits to ratepayers of license contract services have not been answered to the Commission's satisfaction. The record in this Docket contains insufficient evidence for the Commission to find that the amount paid by Mountain Bell for license contract fees is a reasonable expense. Absence demonstration that the payment of $1,207,000 constitutes a reasonable cost, the Commission finds the allowed expense should be held at the level given in its Order No. 3252, Docket No. 5616, Mountain Bell's last general rate case in Montana. The amount allowed is equivalent to one percent of gross local and toll revenues less uncollectibles or $678,000.

47. Hess reduced Montana intrastate Federal income tax expenses by $72,000 to reflect AT&T's tax saving by financing a portion of its investment in subsidiaries with debt. Consistent with its findings on double leverage, the Commission adopts this proposed adjustment on the grounds that the tax deductibility of interest expenses is another cost advantage of debt financing which should be passed along to telephone subscribers.

48. Hess recommended that state and federal income tax expenses be adjusted so they conform with the interest which would have accrued from Dr. Wilson's rate of return recommendation. This adjustment must be made so that expenses reflect interest costs found appropriate for the test year.

49. Rate case expenses are to be amortized over a three year period.

50. Based on the adjustments outlined in Findings 36 through 49, the following table summarizes the Commission's findings as to revenues and expenses during the test year under present rates:

Results of Operations
for the Test Year Ended June 30, 1977
(000)

	Per Books (1)	Adjustments	Adjusted Test Year
1. Local Service Revenues	$ 36,879	-	$ 36,879
2. Toll Service Revenues	27,867	166	28,033
3. Miscellaneous Revenues	4,296	269	4,565
4. Less: Uncollectible Revenues	165	-	165
5. Total Operating Revenues	$ 68,877	$ 435	$ 69,312
6. Maintenance Expenses	$ 11,736	630	$ 12,366
7. Depreciation Expenses	9,483	(265)	9,218
8. Traffic Expenses	6,615	488	7,103
9. Commercial Expenses	7,365	176	7,541
10. Revenue Accounting Expenses	1,402	54	1,456
11. General and Other Expenses	2,463	91	2,554

12. Operating Rents	745	-	745
13. Relief and Pensions	5,105	965	6,070
14. General Services and Licenses	1,207	(529)	678
15. Total Operating Expenses	$46,121	$ 1,610	$47,731
16. Net Operating Revenues	$22,756	$(1,175)	$21,581
17. Federal Income Taxes-Current	$(4,643)	(658)	(5,301)
18. -Deferred	4,809	-	4,809
19. FIT Credit Resulting from Prior Years' Deferrals	372	-	372
20. Investment Tax Credit Realized	4,557	-	4,557
21. Amortization of Investment Tax Credit	372	-	372
22. Net Investment Tax Credit	4,185	-	4,185
23. Net Federal Income Taxes	3,979	(658)	3,321
24. Property Taxes	4,547	-	4,547
25. State Income Taxes	1,200	(101)	1,099
26. Social Security Taxes	1,324	105	1,429
27. Other Taxes	1,204	(5)	1,199
28. Total Operating Taxes	$12,254	$ (659)	$11,595
29. Net Operating Income	$10,502	$ (516)	$ 9,986

(1) As given in Exhibit K, Schedule 2

51. With a test year rate base of $130,467,000, the Applicant earned an adjusted rate of return equal to 8.05% during the year ended June 30, 1977.

PART D

REVENUE REQUIREMENTS

52. The Commission finds that the Applicant experiences an income deficiency of $1,469,000 computed as follows:

	(000)	
Adjusted Rate Base	$130,467a	
Required Rate of Return	8.78%b	
Required Return		$11,455
Adjusted Net Operating Income		9,986c
Income Deficiency		$1,469

a. Finding 32

b. Finding 25

c. Finding 50

53. The revenue deficiency exceeds the income deficiency due to uncollectible revenues and various kinds of taxes whose total is dependent on income.

54. Company witness Leake calculated a revenue-to-income multiplier which included allowances for uncollectible revenue, federal income tax, state income tax, taxes on revenue and taxes on property. (Exhibit 2, page 88). The value of the multiplier was found to be 2.1992.

55. Witness Hess for the Consumer Counsel argued that property taxes should not affect the magnitude of the revenue-to-income multiplier. In Montana the assessed valuation of property depends on capitalization of average earnings in the preceding two years. Unless earnings were abnormally low in those two years, Hess alleged, current property taxes will not be below normal levels and no revenue-to-income multiplier adjustment is required. Hess used a multiplier of 2.10116 which is the Company's revised factor without allowance for property taxes.

56. Since the Applicant has not shown that property taxes in the test year were abnormally low, the revenue-to-income multiplier should not include an adjustment for property taxes. The Commission finds the multiplier value of 2.10116 calculated by Hess to be proper.

57. The income deficiency derived in Finding 52 gives rises to a revenue deficiency of $3,087,000 as follows:

(000)

Income Deficiency	$	1,469
Revenue-to-Income Multiplier	x	2.10116
Revenue Deficiency	$	3,087

58. Implicit in this calculation of Mountain Bell's revenue requirement is the assumption that the Job Development Investment Tax Credit (J.D.I.C.) should be allowed to earn at the overall cost of capital. Through his rebuttal and supplemental testimony, Leake urged this Commission to compute required earnings on the reserve for J.D.I.C. at the equity rate of return. The request for this treatment followed receipt of two IRS information letters by the Company which suggested that the provision for earnings at the overall rate, as proposed in its application, was inappropriate.

59. Hess testified "...I know that most state Commissions have been using an overall rate of return applied to job development investment tax credit, and to my knowledge the Treasury has never indicated to any utility that they are going to lose the investment tax credit because of that practice." (Trans., Vol. III, p. 441, 11. 8-14) On cross-examination, Leake admitted that he was unaware of any utilities who had lost the J.D.I.C. because the regulatory agency permitted only the overall cost of capital on the unamortized balances. (Trans., Vol. III, p. 385, 1. 25) The Commission believes that its treatment of investment tax credits does not endanger the continued availability of these credits and is thus proper.

PART E

RATE STRUCTURE

Cost of Service and Pricing Methodologies

60. Mountain Bell relied upon a residual pricing policy in determining the proposed rates for its service offerings. According to Wallace, this policy involves setting prices to yield "the largest practical net contribution (revenues in excess of direct costs) from the non-basic services so as to keep basic exchange telephone service priced as low as possible". (Exhibit 5 (Phase II) pp. 4-5) In turn, the rates for competitive services were based on long run incremental analysis (LRIA), a methodology which compares direct costs with incremental revenues at various price levels and allows selection of the price that maximizes the contribution of that product to coverage of the utility's common overhead.

The residual revenue requirement, that proportion of the total not derived from competitive services must come from the rates paid by basic exchange subscribers. Applicant's witnesses claimed that LRIA-based rates as proposed by the Company would generate substantial net contributions, allowing the rates for basic exchange service to be set lower than would otherwise be possible.

61. Cross-examination of Company witnesses and the testimony sponsored by protestants addressed the validity of LRIA as a rate-making tool. Testifying on behalf of the Consumer Counsel, Gabel stated his belief that rates should be based on an analysis of fully distributed, rather than incremental, costs. Setting rates equal to fully-distributed costs insured, in Gabel's opinion, the absence of cross subsidies between monopoly and competitive services. Additionally, the witness found fault with Mountain Bell's LRIA since he claimed that the costs which were included understated those actually experienced in providing the services. Gabel warned:

> There is no objective way this Commission can evaluate the reasonableness or propriety of LRIA cost and market studies. These are purely subjective estimates of what may transpire in the future. Nor is there any mechanism for accountability. LRIA costs will never tally with <u>any</u> recorded book costs incurred. As a post hoc evaluation, market forecasts may be shown to have been erroneous. But what then? The competitive products have been mis-priced and the "residual" ratepayer may bear the revenue deficiency. (Exhibit CC-D-2, p. 2, 11.7-14)

62. Intervenor Executone's witness had general and specific criticisms of the long run incremental analysis utilized by Mountain Bell in pricing Dimension PBX and ComKey services. Wilson claimed that LRIA bore no relationship to the economist's conception of long run and that application of the procedure did not result in rates equal to long run marginal costs, an equality necessary if economic efficiency is to be achieved. According to Wilson, LRIA is not long run because the latter assumes all costs are variable while the Company's analysis relies on some fixed overhead costs. The witness further claimed that the proposed LRIA rates were based on Western Electric equipment prices which understated the true costs of these items and on an equated cost of money approach that underestimated capital costs when plant investment is growing.

63. The Commission finds that Mountain Bell's long run incremental analysis is not an appropriate procedure for price setting by a regulated utility selling in both monopoly and competitive markets. Responsible regulation by this Commission is premised on its ability to compare rates with the cost of service, insuring that the proposed rates are compensatory. By relying on forecasted costs and market conditions, LRIA provides less assurance that rates will cover actual costs than does a comparison of rates with historic costs. LRIA considers only those costs the utility regards as incremental, thus creating the possibility of cross subsidization if rates based on such analysis do not cover full costs including an allocation of common overheads. With the Company's residual pricing policy, the potential subsidy would be from basic exchange ratepayers to those using competitive services.

64. As an alternative to Mountain Bell's pricing methodology, Gabel recommended that the rates approved in this Docket be based on the cost of service study he performed. This study assigned costs to five service categories on a fully distributed basis. For 1976, the following rates of return were found:

Exchange	44.1%
Message Toll	5..3%
Private Line	..5%
Vertical	(8..5)%
Other	6.7%
TOTAL	8.0%

(Exhibit CC-A-2, Exhibit Page 1)

65. Altig, from the staff of Mountain Bell, alleged three serious deficiencies in Gabel's cost of service study; these were: (1) the mis-specification of service categories; (2) incorrect assignment of some revenues and expenses; and (3) improper use of separations procedures. Unruh also criticized the cost of service methodology employed by Gabel. From his perspective as an economist, Dr. Alessio testified, "Cost assignments based on fully distributed cost techniques as proposed by Mr. Gabel also are not cost-causative and, in fact, are misleading and likely to produce rate levels that will be harmful to the basic service customer". (Exhibit 20, p. 8, 11. 14-17)

66. Gabel did not use the results of his cost of service study as the basis for specific rate recommendations. After identifying the service categories with revenue deficiencies,

the witness stated, "The rate increases may be invoked as flat across-the-board percentage adjustments or on a selected equipment basis. (Exhibit CC-C-2, p. 3, 11. 7-8) In response to Commission examination by Mr. Burchett, Gabel acknowledged, "This study--I tried to say earlier and perhaps not very clearly, is an approach either to follow or to provide you a raw measure of the revenue condition of the respective service classifications. It doesn't tell you a rate for any particular service". (Trans., Vol. X, p. 739, 11. 2-8) Because the study stops short of determining individual cost-based rates and provides no guidelines for doing so, the Commission finds Gabel's cost of service study incomplete.

67. To insure the absence of cross subsidies, rates for telephone services should be set equal to fully-distributed costs. Although Gabel's study is incomplete, it does provide a foundation for the determination of such costs and compensatory rates. A subsequent Order paragraph will mandate completion of the study for this purpose.

68. Wilson employed the GE-100 methodology developed by the California Public Utilities Commission Staff to compute what he felt were compensatory rates for representative Dimension and ComKey instruments with various contract lengths. Involved in his computations is the utilization of historic expense-investment relationships to derive the costs associated with these service offerings. Despite Wilson's description of his method as long run marginal cost pricing, it differs little from Gabel's which is based on embedded costs; the latter expresses conceptual agreement with Wilson. (Trans., Vol. X, p. 634, 1..3) Both studies seek to determine fully-distributed costs as the basis for rate setting. The Commission is persuaded that Wilson's methodology provides the proper basis for setting Dimension and ComKey rates.

69. Due to the deficiencies of Mountain Bell's Long Run Incremental Analysis and residual pricing policy discussed in Finding of Fact No. 63, the Commission strongly urges the utility to base future rate applications on a fully-distributed cost study.

70. While Gabel's cost study was not accompanied by proposed rates for individual services, it did delineate broad service categories with below-average returns. Specifically, Gabel calculated that private line services had a return of 0.5 percent in 1976; the rate of return on vertical services was a negative 8..5 percent. The Company's own Embedded Direct Cost Study for the same year also found return deficiencies in the private line and vertical services categories. (Exhibit 21A, Attachment 1) Applicant and the Consumer Counsel agreed to the need for increased rates in these two areas; the Commission concurs.

Two-tier Pricing

71. Mountain Bell proposed two-tier rate schedules in many categories of private branch exchange (PBX) and key telephone systems, two types of vertical services. In Consolidated Docket No. 6496, Applicant sought regulatory approval of two-tier rates for Dimension 100 PBX, Dimension 2000 PBX and ComKey 416. At the time of filing, these were new services whose rates have since received temporary approval. Two-tier pricing of other business terminal equipment had been approved prior to that time.

72. The term "two-tier" describes the components of rates which characterize this type of pricing. What Mountain Bell labels Tier A is a rate designed to cover the capital-related costs of providing the necessary equipment at the customer's premises; according to the Company's proposed tariffs, this rate would remain constant for the duration of the contract between the utility and the subscriber.

73. The Tier B rate component has two segments: (a) the fixed portion of Tier B, equal to 18 percent of Tier A and continuing over the life of the contract; and (b) the variable portion, intended to cover the expenses of maintenance, administration and repairs and subject to change with Commission approval.

74. Those choosing to purchase services offered with two-tier rates have the option initially of choosing conventional month-to-month rates rather than signing a Tela-Lease contract. Mountain Bell contended that approval of two-tier pricing is necessary if the Company is to be able to compete with its unregulated rivals who can offer similar equipment under long-term lease agreements.

75. The Consumer Counsel attacked Applicant's proposed two-tier rates on several grounds. These included the alleged deficiencies of LRIA previously discussed and the reliance on an equated cost of money approach to pricing which necessarily resulted in the subsidization of competitive by monopoly services.

76. More broad based than that of MCC, Executone's attack on two-tier pricing struck at the concept itself as well as the level of rates sought. Testifying on behalf of the Intervenor, Dr. Wilson contended that the proposed rates were non-compensatory because some relevant costs had been ignored. The short-run nature of LRIA coupled with its understatement of true Western Electric equipment costs and failure to account properly for premature retirement led, in Wilson's opinion, to two-tier rates which did not cover costs. At the conceptual level, Executone argued that the Company's two-tier proposals were:

(a) inherently discriminatory in their insulation of certain customer classes from future rate increases.

(b) non-compensatory through the assumption that each customer will pay the full capital costs associated with his equipment while allowing a credit for the reusable value of that equipment should he choose to terminate service early.

(c) illegal since the proposed Tela-Lease contract would not allow this Commission to regulate utility rates on an ongoing basis.

(d) exclusionary and anti-competitive by locking out competitors for the life of the contract.

Contract Terms

77. Included in the Tela-Lease contract is the provision that tier A rates will remain unchanged for the duration of the lease. The Commission reserves the right to change this portion of the two tier when its analysis indicates that an adjustment is warranted. To do otherwise would be to abrogate the Commission's responsibility for ongoing regulation of utility rates. The Tela-Lease contract shall inform customers that tier A payments may be changed by Commission action.

78. While it claimed that tier A payments under Tela-Lease were designed to recover all capital costs attributable to an individual piece of communications equipment, Mountain Bell proposed to allow subscribers a reuse credit for their equipment when they terminate early. According to the terms of Tela-Lease, the amount of the credit is determined by the utility following an evaluation by its engineering staff. This procedure would potentially allow Mountain Bell broad discretion in assigning reuse value. To protect lessees and ratepayers in general, the Commission finds that the reuse credit to be applied against the present worth of remaining tier A payments should be determined by assuming a straight-line depreciation schedule based on service life; deviations from this norm shall require explanations to the lessee and this Commission.

79. Although Mountain Bell describes its rates as "two-tier," the proposed rates actually have three components as enumerated in Findings 72 and 73. To improve customer understanding, the Commission finds that all capital-related costs should be covered by the Tier A payment and all other costs by Tier B. The tariffs shall contain no rate labeled the "fixed portion of the variable rent."

Level of Rates

80. Intervenor Executone alleged underestimation of costs in Mountain Bell's long run incremental analysis of Dimension and ComKey; the grounds for this allegation were:

(a) improper inclusion of Dimension in the Customer Premises Product Line (CPPL) when, technologically, it belongs with Dial Products.

(b) underallocation of research and development costs to Dimension and ComKey.

(c) utilization of an equated cost of money (ECM) approach to undepreciated investment.

(d) inadequate assignment of administrative expenses.

81. Adding to Executone's criticism, Gabel contended that the wage rates estimated for installation labor in computing long run incremental costs were below those actually paid by Mountain Bell.

82. Subsequent findings will address these contentions individually in determining the appropriate level of two-tier rates.

83. Extensive testimony was received by the Commission on the motivation for and propriety of including Dimension in the CPPL for pricing purposes. Wilson argued that Western Electric and its parent, AT&T, chose to place the new PBX in the Customer Premises Product Line so that the resulting equipment costs would be more competitive with those of other manufacturers. Considering the technology embodied in Dimension, Professor Collins opined that it was more like dial products than others in the CPPL.

84. Relying on the testimony of Messrs. Hendrickson and Thornton and Dr. Horenkamp, Mountain Bell attempted to refute the allegations of Intervenor's witnesses. Hendrickson, who attended the WECo meeting where formation of the CPPL was approved, stated that the product line contained technologically similar equipment which all faced competition in the marketplace; price considerations did not enter the decision. Thornton added that the relationship of expense to standard cost varied little within the CPPL. Horenkamp expressed his engineering judgment that "there is a high degree of commonality between the DIMENSION PBX, COMKEY and other members of the Customer Premises Product Line" (Exhibit 27, p. 3); these products are "highly interactive

with each other and they typically share similar interfaces, environmental considerations and maintenance philosophies." (Exhibit 27, p. 26).

85. In examination by Commissioner Schneider, Thornton described the Customer Premises Product Line as a "continuum of products" ranging from " the single line non-Key telephone set which you put at one extreme of the continuum and the Dimension PBX at the other end." (Trans., Vol. VII, pp. 161-162). Testimony of witnesses for both Applicant and Executone confirm the aptness of Thornton's description, particularly the placement of Dimension at the technologically complex end of the continuum. As a complex PBX, Dimension does exhibit similarity with switching vehicles in the dial products line. Because Dimension has certain features shared with Customer Premises Products and others characteristic of dial products, the Commission finds that, for rate-making purposes, Dimension should be assigned a price factor of 1.58, the arithmetic mean of the July 1, 1977 factors for the CPPL and the Dial Products Line.

86. In addition to applying the dial line price factor to Dimension, Wilson argued that the equipment costs of Dimension and ComKey should be increased through an upward adjustment of approximately 15 percent in the price factors applied to standard costs. This adjustment was advanced on the grounds that, in its absence, the two products would not bear a proper share of research and development expenses funded through license contract fees paid AT&T.

87. On behalf of Mountain Bell, Mr. Callahan argued that fundamental development is basic research and, as such, does not relate to particular products; he continued:

> The license contract obligates AT&T to undertake the work of research and fundamental development to insure continual improvements in telecommunications and to develop techniques to assure the efficiency and quality of telephone systems. Thus, the reimbursement of AT&T for the performance of such work through License Contract payments is entirely appropriate. (Exhibit 24, p. 7. 11. 5-11).

88. Cross-examination of Callahan revealed that many of the projects classified as fundamental development pertained to specific products, particularly the Dimension PBX. For Dimension, then, a basis exists for the adjustment of the price factor proposed by Wilson; this PBX has been benefited by a disproportionately large share of development

expenses. However, the Commission finds no evidence in the record to support a similar adjustment in the price factor applied to ComKey costs.

89. When questioned by Executone counsel, Gabel expressed conceptual agreement with Wilson's testimony but stated that the Company labor and material costs used therein understated actual investment. (Trans., Vol. X, p. 634). Responding to criticism of the PBX labor rate, Unruh stated, "Mr. Gabel's assertion that Mountain Bell systematically understated labor rates is based on his erroneous use of a rate not developed and not suitable for an economic analysis." (Exhibit 23, p. 14, 11. 11-13). Dimension cost studies had not used the $23.00 wage rate criticized by Gabel because it was not the cost actually incurred in Montana. Cross-examination of Gabel exposed the error in his contention that Dimension and ComKey material costs were understated; the February 1978 prices given in Exhibit CC-E-2 were shown to be very close to those employed in the Company's cost analysis. (Trans. Vol. XX, pp. 654-5). The Commission finds no fault with the Company's labor and material costs; their utilization by Wilson is not a cause of underestimated investment.

90. According to Mountain Bell's proposal, tier A payments would remain constant over the contract term. In contrast, the return requirement on undepreciated investment which these payments are designed to recover declines annually. Applicant utilized an equated cost of money approach to convert the secularly changing capital costs to a uniform annual equivalent for tier A. With this approach, the equivalent return is computed on each asset individually; the annualized base for computing the return is 62.54 percent of the initial investment. (Exhibit 6, p. 16, 1. 1).

91. Wilson chose a forecasted growth reserve (FGR) method over the ECM approach to compute tier A payments; FGR computes return on the average undepreciated balance for all similar assets. In Wilson's opinion, the method he selected was more appropriate in light of anticipated growth in Dimension and ComKey investment. To use ECM would underestimate undepreciated investment and result in incomplete recovery of capital costs.

92. The ECM-FGR debate revolves around the question: are Dimension and ComKey services provided by single units of investment or assets which are members of a pool? In Finding of Fact No. 77, the Commission has rejected the proposal of unchanging tier A payments which would have resulted in vintage pricing. Consistent with that earlier Finding, the equated cost of money method is rejected in favor of the forecasted growth

reserve approach which computes the return requirement on average net investment in an equipment account rather than on average investment in a single piece of equipment. An undepreciated balance of 77.98 percent shall be used for PBX's and 80.03 percent for key telephone systems.

93. To provide consistency, depreciation expenses shall be calculated on the average years of life implicit in the undepreciated investment balances found appropriate above.

94. Arguing that most administrative costs could not be assigned to individual services, Mountain Bell used an administrative expense factor of 2.5 percent to represent variable costs. If LRIA were truly a long run study, all costs would have been considered variable. Wilson recommended that long run marginal costs be approximated by assigning overhead costs to Dimension PBX and ComKey on a pro rata basis using figures from the Company's Form M Report to the FCC. The Commission accepts Wilson's recommendation as an appropriate methodology to insure that rates for each service cover all costs. Administrative expenses shall be allocated as 10. 24 percent of investment.

95. Mountain Bell's LRIC studies calculated the maintenance expense by estimating the number of hours necessary to perform maintenance work. In contrast, Wilson used the 1976 ratio of total maintenance expenses to plant to derive a factor applied to Dimension PBX investment. Brown argued that the Company's lower cost estimate was appropriate since the electronic PBX required fewer and simpler maintenance operations. (Exhibit 6, p. 33-4). Introduced as Exhibit ESM-4, a letter from C. D. Taylor, district manager in Mountain Bell's Economic Analysis Division, to Art Brandon, Special Design Engineer, expressed concern with the high level of maintenance expense actually experienced on Dimension PBX systems. Despite the discrepancy between actual and estimated costs, the utility has chosen not to adjust the level of maintenance expense assumed in its Dimension cost studies. (Trans., Vol. IX, p. 552, 1. 15). The Commission accepts Wilson's methodology in computing maintenance expenses for Dimension and ComKey as being more reflective of costs incurred than that employed by the Company.

96. The expense-to-investment ratios for sales tax, supply expenses, maintenance, administration, other taxes and other annual charges used by Wilson were the results of dividing each expense by the Western Electric invoice price. By applying the ratios thus derived to the adjusted equipment costs for Dimension and ComKey, Wilson has overstated each cost. The Commission finds that the ratios should properly be multiplied by the

invoice price to determine each expense; the adjusted Western Electric equipment costs should be used only for determining depreciation and the return on investment.

97. The Western Electric tax deferral shall be computed as 3.98 percent of investment for both Dimension and ComKey which corresponds with actual experience. Again, this deferral shall be computed on the invoice price.

98. Although Brown criticizes Wilson for excluding the impact of accelerated tax depreciation and the investment tax credit (Exhibit 6, p. 47, 11. 9-12), he makes no adjustment to the income factor in "correcting" Wilson's two-tier cost analysis (for example, see Exhibit 6, Appendix E, page 3). Computation of taxes as 9. 55 percent of depreciated investment is found appropriate by this Commission..

99. Two-tier rates for ComKey 416, Dimension 100 PBX, Dimension 2000 PBX, Dimension Custom Telephone Service, Feature Packages 4 and 5 for Dimension 400-PBX and additional Hotel/Motel Features for Dimension 400 PBX shall be determined by computing the costs of service using the Findings under the heading Level of Rates and setting the rates equal to these costs.

Conventional Rates for Services Offered with Two-tier Pricing

100. Month-to-month, conventional rates shall be determined in the manner prescribed by Finding of Fact No. 99 with the exception that the estimated location life be used in place of the contract term.

Dimension 400PBX, ComKey's 718, 1434 and 2152

101. In Consolidated Docket No. 6496, Mountain Bell sought approval of its proposed tariffs for Dimension 100 and Dimension 2000. The other member of the family, Dimension 400, has been offered in Montana since September 1976. Rates for Dimension 400 were an issue in this Docket only to the extent that the Company requested allowance of tariffs for Feature Packages 4 and 5 and additional Hotel/Motel Features on that PBX. Consequently, the Commission can, at this time, mandate that rates for only Dimension 100 and Dimension 2000 be computed in accordance with the preceding Findings. However, since the tariffs now approved for Dimension 400 employ the Long Run Incremental

Analysis with which this Commission has herein found fault, the Commission is not convinced that these rates are compensatory. In light of testimony received in Docket No. 6496 and its Findings in this Order, the Commission has determined that it should reexamine the rates previously approved for Dimension 400 PBX service.

102. Similarly, the Commission finds that its authority to order changes in rates for ComKey service is limited to the ComKey 416. Tariffs for the other members of the ComKey family, ComKey 718, ComKey 1434 and ComKey 2152, were approved in December, 1976. Because LRIA was the basis for all ComKey filings, the Commission believes that rates for ComKey 718, ComKey 1434 and ComKey 2152 services should be reexamined to insure that they cover all costs as defined by the Findings of this Order.

43 Teleprinter

103. Since the 43 Teleprinter has been offered in Montana for only a short period of time, little historic cost information exists on which to base rates for this service. Absent data to the contrary, the Commission finds the rates proposed by Mountain Bell for this service reasonable.

Optional Centrex Services with Number 1 ESS

104. Three optional services are available to centrex customers served from No. 1 ESS central offices suitably equipped; these services are: automatic route selection, station message detail recording and customer dialed account recording. Because the three were new features in 1977, cost-of-service information is limited. The proposed rates for these centrex options are judged reasonable by this Commission.

Other Vertical Services

105. In its application, Mountain Bell proposed rate increases in a number of service categories, wholly or partially vertical services, which have not been considered to this point. These were:

Mobile Service

Non-Pub/Non-List

Extension Telephones

Special Assemblies

Special Systems and Services

Companion Line Service

Non-Dimension Private Branch Exchange Services

Non-ComKey Multi-line Telephone Services

Centrex Service

Secretarial Bureau Service

Mileage Charges

Service Stations

106. While Gabel's fully distributed cost study confirmed the appropriateness of rate increases for vertical services, it did not determine cost-based rates for individual service offerings. Absent alternative rate proposals, rates for the vertical service portions of the categories listed in the preceding Finding shall be changed to the levels applied for by the Company. The revenue increase thus generated will raise the rate of return from these services toward the overall level authorized herein.

107. The Commission is persuaded that fully distributed costs are the appropriate foundation for rate setting. Consequently, Order Paragraph No. 4 will mandate completion of Gabel's cost of service study to determine expenses associated with individual vertical service offerings.

Private Line Services

108. The appropriateness of higher rates for private line services was demonstrated in studies by Mountain Bell and by the Consumer Counsel which found current revenues from this category inadequate to cover costs. Until a more detailed study is completed, the Company proposed that rates be increased to generate $175,636 of additional private line revenues over those of its test year. Although recognizing that there is currently no cost basis for the individual rate proposals, this Commission approves these rates as a means of reducing the revenue deficiency due to private line services. When those studies now underway are completed, further rate changes may appear warranted and will be considered by the Commission following an application from Mountain Bell.

Intrastate Toll Schedules

109. Mountain Bell proposed changes in intrastate toll schedules which would bring them into uniformity with the interstate schedules. Specifically, the Company sought authorization to initiate one-minute direct distance dialing-rates and to increase charges to the level of those for interstate calls of comparable distance. McDonald claimed that uniform schedules would "improve customer understanding and ease of administration of the tariffs and meet customer calling needs." (Exhibit 1A, p. 22, 11. 1-2)

110. Gabel argued that Mountain Bell underestimated revenue from the proposed changes by assuming more suppression of toll calling than the witness felt likely to occur based upon the reactions of consumers in other states where similar rates changes had been imposed. In addition, Gabel recommended that a rate differential be established between coin-originated and other operator-handled calls and that a time-of-day discount be given on toll calls between noon and two o'clock PM.

111. The Commission finds no need for added revenues from message toll users; both Gabel's cost study and the EDC analysis of Mountain Bell show a positive return from state toll service. Although a revenue increase is not warranted, merit is apparent in the Company's proposal for uniformity in the intra- and interstate schedules. Consequently, the Commission authorizes Mountain Bell to file new intrastate toll tariffs which contain a one-minute initial period charge for DDD calls and provide no revenues in excess of those for the test year from this category. These rates shall be developed by dividing the current initial three minutes DDD rate by three, rounding to insure that the new rates yield the same revenue as the old for a call of equal duration.

112. The Commission believes that rates so derived will produce revenues equal to test-year revenues from state message toll due to two offsetting changes they will cause: (a) revenue will be lost through lower charges than previously for one-and two-minute calls; and (b) the lower initial period charge will encourage customers to make more calls of short duration than they do under present schedules and thus result in increased revenues.

113. The other changes in state message toll tariffs proposed by Gabel are rejected since he provided no cost justification.

Local Coin Rate

114. Mountain Bell requested an increase in the local coin rate from 10¢ to 20¢. At the current rate, average revenue per station, $22..51, fell short of covering monthly average costs, $37..56 (Exhibit 5A (Phase I), p. 46, ll. 2-4); this shortfall provided one basis for the Company's request. Since the coin phone rate was last increased in 1953, local calling areas have expanded which, in Wallace's opinion, was a value-of-service justification for the proposed increase.

115. According to Gabel, the revenue deficiency found for coin telephones resulted from the mismatching of revenues and expenses. The witness contended that Mountain Bell had compared the revenues from local coin service with expenses covering both toll and local. After adding intrastate toll revenues and subtracting interstate expenses, Gabel found average monthly revenue of $29.72 compared with a net state jurisdictional cost of $25.54. (Exhibit CC-Q-1, p. 3) Because revenues appeared adequate to cover expenses, Gabel concluded that no increase in the coin telephone rate was required.

116. By including toll costs with local, the Company has overstated the expenses associated with the provision of local coin service. Mountain Bell's failure to compare local revenues with local costs compels this Commission to reject its proposal for an increase in the coin telephone message rate for lack of cost justification.

Service Charges

117. Applicant proposed increasing service charges to generate $1,013,942 of additional revenue based on the Company's test year. These charges apply to the ordering, installing, moving and changing of telephone service, facilities, supplemental and miscellaneous equipment. In support of increased charges, Wallace argued that revised schedules were needed to bring revenues closer to the costs incurred in service work and to structure charges so they reflect the work elements actually performed. (Exhibit 5A (Phase I), pp. 30-31. The exchange service charges requested totaled a 58.9 percent increase over current revenues, consisting of a 71.7 percent increase for residential users and 38.7 percent for businesses. Presently, there are no charges for private line service orders; imposition of the proposed charges would generate $31,077 of revenue.

118. Through Exhibit CC-C-2, Gabel contended, "Although the Company has overstated the cost of service connection work, the fact is rates undoubtedly do not cover the expenses incurred in providing service connection, move and service restoration. A rate increase, smaller than the Company has proposed, is warranted." (p. 3, 11. 16-19) However, cross-examination revealed that the witness had conducted no study to determine the alleged overestimation of costs.

119. Mountain Bell and the Consumer Counsel agreed that the costs of service work exceed current charges; both recommended increased charges. The Commission recognizes the appropriateness of an increase in service charges to reduce the subsidy now flowing from ratepayers who do not change their telephone service frequently to those who do. While the increases proposed by the Company are substantial, it has demonstrated that the increased charges are not excessive relative to costs and would force subscribers who change their service to bear more of the costs for which they are responsible. The service charge changes requested by Applicant are, therefore, approved in their entirety.

120. At present, Mountain Bell charges customers $3.00 to restore telephone service when it has been temporarily suspended for nonpayment; its application proposed increases to $5.50 for residences and $11.50 for businesses. Customers desiring a temporary suspension of service now receive this service without charge. Mountain Bell requested approval of suspension charges of $5.50 and $11.50 for residential and business users, respectively, with equal charges for restoration. Using its 1977 test-year quantities, the Company projected a revenue increase of $54,271. These charges are found appropriate for the same reasons as given in the preceding Finding.

Maintenance of Service Charge

121. A maintenance of service charge is imposed "for each repair visit by Mountain Bell to a customer's premises in connection with a service difficulty when it is determined that the problem is caused by a condition in customer provided terminal equipment or communication system." (Exhibit 5A, Phase I, p. 59, 11. 3-6) To cover all costs involved in providing this service, Applicant recommended that the charge be increased from $10.00 to $27.00.

122. In his Reply Brief, the Consumer Counsel urged the Commission to limit the maintenance of service charge to $15.00. Arguing that the Company had provided no cost justification for its request, the Brief suggested that a $5.00 increase was sufficient.

123. The Commission finds no evidence in the record to support an increase in the maintenance of service charge to $27.00. Since both Mountain Bell and the Consumer Counsel agree that some increase is warranted, a $15.00 charge is approved.

Credit for Customer-provided Telephone Set

124. In recognition of its cost savings, Mountain Bell sought approval for a monthly credit of $.60 to customers who provide their own telephone sets. Gabel urged the Commission to order a credit of $.70; his recommendation was based on a consideration of expenses the Company avoids when a subscriber provides his own set. Attached to Unruh's rebuttal testimony was a "correction" of Gabel's calculations, using figures which Unruh felt were more appropriate and which supported the $.60 credit.

125. In his Reply Brief, the Consumer Counsel argued that the estimated distribution of new and refurbished sets was the "crux of the difference in these recommendations." He continued, "Mountain Bell assumes that current (14%) ratio of handsets is a valid representation of telephones for all times. The Company claims to be examining 'forward looking costs' (Exhibit 23, p. 7). One need not look very far forward to recognize that under conditions of market competition, provision of customer handsets will change markedly, including the shortening of service lines [sic]." (p. 20, 11. 12-20).

126. The Commission agrees that the 1971-76 historic distribution of new and refurbished sets underestimates the proportion of new sets which will occur when the FCC registration program has made its impact felt; competition in the supply of telephone equipment can be expected to shorten service lives, leading to a greater proportion of new sets being installed. Consequently, the Commission finds that the one-to-three ratio of new to refurbished sets proposed by Gabel is a reasonable estimate to be used in determining the set credit.

127. When loadings for field stock, supply expense and the Western Electric tax deferral are included elsewhere, $20.45 and $12.29 are the correct costs for new and refurbished sets, respectively.

128. Annual maintenance savings due to a customer-provided set should reflect those costs associated with the telephone instrument itself; thus, the proper maintenance savings is $2. 95 per year.

129. Consistent with his advocacy of a fully distributed cost standard in rate making, Gabel recommends that administrative expenses be calculated as 7.2 percent of investment, a figure derived in Schedule 8 of Exhibit CC-B-2. Mountain Bell used a factor of 2.89 percent which Unruh argued represents variable administrative expenses. The Commission believes that use of the 7.2 percent figure results in the appropriate allocation of administrative expenses.

130. The Consumer Counsel's witness and Mountain Bell agreed upon the remaining expense-to-investment ratios utilized in computing the set credit; this Commission concurs in the propriety of the ratios used by both parties.

131. Employing the methodology found in Exhibit 23, a monthly expense saving of $.66 is calculated as follows:

I. First Cost	Unit Cost	Estimated Distribution	Weighted Cost
New Sets	$20.45	25%	$ 5.11
Refurbished Sets	$12.29	75%	9.22
Weighted Cost			$14.33
Loading for Field Stock, Supply Expense and WECo deferred taxes (6. 63%)			.95
TOTAL			$15.28

II. Annual Expenses

1.	Maintenance	$ 2.95
2.	Depreciation (4.6%)	.70
3.	Cost of Money (12%)	1.83
4.	Income Tax (5.98%)	.91
5.	Administration (7.2%)	1.10
6.	Ad Valorem Rate (2.3%)	.35
7.	Sub-total	$ 7.84
8.	Gross Receipt Tax (1.1%)	.08
9.	Annual Expenses Saved	$ 7.92
10.	Monthly Expenses Saved	.66

Expense savings at this level justify a monthly credit of $.70 to customers who provide their own telephone sets.

Exchange Reqrouping

132. Through its proposed tariffs, Mountain Bell requested the reclassification of forty-four (44) exchanges which had outgrown their present exchange groups. Such reclassification would result in $942,650 of increased annual revenues. Interim approval was granted on the grounds that the changes were necessary for inter-exchange equity; permanent reclassification is allowed for the same reason.

Local Exchange Rates

133. The Commission believes that the rate increases authorized by the Commission to this point will exceed the revenue requirement of $3,087,000. If such is the case, rates for local exchange service will be reduced to limit the net revenue change to the revenue requirement found in this Order.

134. The necessary reduction in local exchange revenues shall be calculated as follows:

(a) Sum the revenue impacts of the rate changes approved in the preceding Findings.

(b) From this total, subtract $3,087,000, the revenue requirement.

(c) The difference between (a) and (b) is the amount by which local service revenues must be reduced.

135. To effect the revenue decrease, rates for local exchange services must be lowered. The reduction shall be a constant percentage of current rates for these services, the percent equal to the ratio of (c) above to test year revenues from local exchange services.

136. Local exchange service is hereby defined as individual line, two-party line and four-party line services for business and residential subscribers and rural eight-party service.

CONCLUSIONS OF LAW

1. The rate base determined in Finding of Fact No. 32 reflects the original cost depreciated value of Applicant's telephone plant allocated to Montana intrastate operations. These values comply with the requirement of R.C.M. 1947, Sec. 70-106 that the value placed upon a utility's property for rate making purposes "shall not exceed the original cost of the property."

2. Use of an average historic rate base is an appropriate means of measuring the value of Applicant's properties at risk during the test period. In addition, average rate base values permit a better matching of test year revenues and expenses with the properties which produced them than do year end values.

3. Construction work in progress is excluded from rate base for consistency with R.C.M. 1947, Sec. 70-106 which directs that before the property of a public utility can be included in the rate base, that property must be used and useful for the convenience of the public.

4. As ratepayers should not be forced to provide a return on funds which they have furnished a utility, the exclusion of customer-contributed capital from rate base is proper. Pre-1971 accumulations of deferred investment tax credits can be treated as a rate base reduction without endangering Applicant's right to claim these credits.

5. The rate of return allowed in this Order meets the constitutional requirement that a public utility's return must be "commensurate with the returns on investments in other enterprises having corresponding risks and sufficient to insure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." Federal Power Commission v. Hone Natural Gas Company, 320 U.S. 591, 603 (1944). It, likewise, complies with the dictates of R.C.M. 1947, Sec. 70-105, which provides that a public utility has the right to receive a fair return on the value of its property used in service.

6. The rate structures authorized herein are just, reasonable and not unjustly discriminatory.

ORDER

THE MONTANA PUBLIC SERVICE COMMISSION ORDERS THAT:

1. The Mountain States Telephone and Telegraph Company shall file rate schedules designed to produce a revenue increase of $3,087,000 from its Montana subscribers. This increase is in lieu of rather than in addition to those granted on an interim basis. The tariffs shall be effective upon their approval by the Commission.

2. The increased revenues authorized herein shall be distributed among tariffed services as described in the Findings of Fact of this Order.

3. Pursuant to R.C.M. 1947, 70-121 which allows investigation of rates upon motion of the Commission, an investigation of the rates charged for Dimension 400 PBX, ComKey 718, ComKey 1434 and ComKey 2152 services is ordered to determine if these rates are just and reasonable.

4. Mountain Bell is ordered to undertake a fully distributed cost study to determine the costs associated with the vertical service offerings listed in Finding of Fact No. 105. Before the study commences, representatives of Mountain Bell, the Commission, Executone and the Consumer Counsel shall meet to define guidelines, consistent with Gabel's cost of service study, for computing costs. The purpose of this study is to ascertain the reasonableness of vertical service rates herein approved. Completion of the new study shall be within four months from issuance of this Order.

5. All motions and objections not ruled upon at the hearing are denied.

BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION.

Gordon E. Bollinger, Chairman

P.J. Gilfeather, Commissioner

Thomas J. Schneider, Commissioner

James R. Shea, Commissioner

George Turman, Commissioner

ATTEST:

Joyce R. Baumberger
Acting Secretary

(SEAL)

NOTICE: You are entitled to judicial review of the final decision in this matter. If no Motion For Reconsideration is filed judicial review may be obtained by filing a petition for review within thirty (30) days from the service of this order. If a Motion For Reconsideration is filed, a Commission order is final for purpose of appeal upon the entry of a ruling on that motion, or upon the passage of ten (10) days following the filing of that motion. cf. The Montana Administrative Procedure Act, esp. Section 82-4216, RCM 1947; and Commission Rules of Practice and Procedure, esp. 38-2.2 (64)-P2750, ARM.